QUARTERLY REVIEW – DECEMBER 2013

In overall terms, 2013 was a favourable year for global equities. The Australian share market (ASX 200) finished the year up around 15% whilst the US Dow Jones managed to post another record-breaking year returning 26% over calendar 2013.

As in previous years, the sector-based performance within the Australian market differed materially. Banks outperformed for a third successive year generating a 36% return, whilst at the other end of the spectrum materials (or resource stocks) struggled hard to stay out of the red (-0.8%). Given these two sectors between them account for around 60% of the Australian bourse, its not surprising that the average market return lay somewhere in between. Interestingly, what did become more apparent in the second half of the year was an increased appetite for "risk stocks" (including materials, industrials and cyclicals). As global economic growth continues to strengthen (the Eurozone has now been out of recession for two consecutive quarters) and concerns around sovereign debt progressively subside, we expect this rotation towards more risky assets to gain further momentum - albeit likely punctuated, once again, by periods of volatility.

Investor confidence (or conversely fear) is likely to continue to be driven by the economic performance of the US and China.

US Economy

No matter which data source you care to examine, the US economy is continuing on its path to recovery. Employment, housing, manufacturing, etc are all steadily improving. Add to this, the growth in earnings of corporates (together with the health of their balance sheets) and the increasing self-reliance the nation has around oil and gas and the medium term outlook is rosy for the US.

Somewhat understandably, the price to be paid for all this good economic news is the tapering, by the Federal Reserve, of its asset-buying programme (which has been pumping liquidity into the financial markets and the real economy). In December, the Fed announced that it would trim its treasury and mortgage-back security purchases by a total of $10bn in early 2014. It is likely that the programme will be cut-back further in the coming months. In anticipation of this tapering, longer term interest rates in the US have begun to rise and the USD has strengthened against all currencies, particularly those of emerging nations (many of the emerging markets have been damaged by the sudden repatriation of USD funds). As a result, the AUD has also fallen against the green-back with some economists predicting that the AUD will sit around USD0.82 by the end of 2014 (a fall which will be overwhelmingly positive for the Australian economy and share market).

The only dark cloud on the horizon in the US is the renegotiation of the debt ceiling, due by 7 February. However, for the reasons articulated last quarter (ie, the threat to republicans political credibility and the amended voting mechanics around raising the ceiling) we believe that there will be little in the way of significant spillover this time around.

China

The economic data out of China continues to meet expectations. The Chinese Authorities have flagged for some time their desire to slow economic growth and they have delivered on this promise (December quarter GDP was 7.7%pa). Whilst critics argue that this is well below long-term averages, Chinese growth had previously been driven to unsustainable levels by Government spending and borrowing. The Government is now keen to slow growth to around 7.5% and constrain the availability of credit (particularly in the shadow banking sector – see below). As part of this economic re-engineering they are also looking to move the focus from export focused activity to internally generated growth (including consumer spending).

The one potential negative we should be prepared for in China in 2014 is the failure of at least one financing Trust. These trusts are an integral part of the so-called shadow banking system and involve high net worth individuals investing funds in off-balance sheet Trusts marketed by the banks. These trusts then on-lend money (sometimes further gearing their positions) to less reputable commercial companies and property developers. There has always been an assumed implicit guarantee from the Trust Company (some of which have significant capital reserves), Local Government Authorities (who also involve themselves in this market) and the distributing banks (who sell the investments to wealthy Chinese clients).

The problem with this type of activity is that it has now reached significant proportions, is being miss-priced because of the implicit guarantee and is fuelling unsustainable growth (read "asset bubbles") in certain parts of the economy. The answer for Chinese authorities will be simple – let a few of the Trusts fail. This will significantly curtail the flow of funds into these type of vehicles and where it does still occur interest rates will be much higher. This type of deleveraging will further aid the sustainability of economic growth.

There are some out there still predicting a hard landing for China – due in large part to the fear of the type of asset bubbles mentioned above. However, the Chinese authorities have consistently demonstrated a propensity to guide the economy in the required direction and this time is likely to be no different.

Jonathon Pain (author of the renowned "Pain Report" and acknowledged for his contrarian economic views) has recently penned his thoughts around 2014 and his number one prediction is the anticipated outperformance of China. He even went so far as to advocate selling down some US exposure (an economy which he is still very positive about) in order to up-weight China.

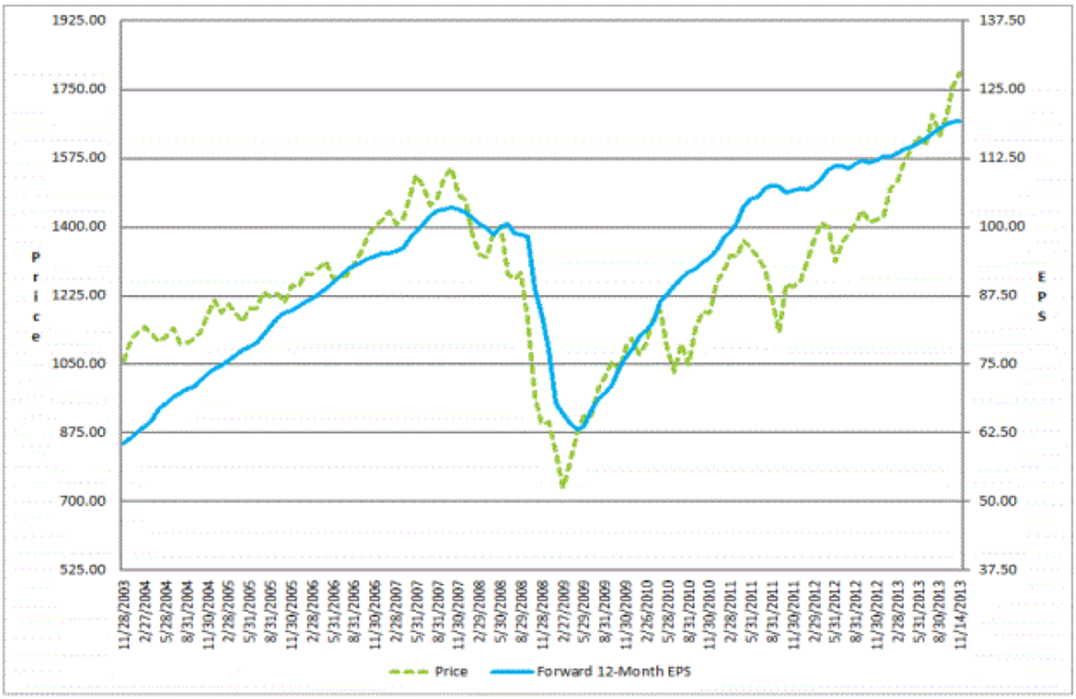
He noted that the current President Xi Jinping "is a reformist and I believe the decisions that were reached recently at the third plenum in Beijing are incredibly positive and will lead the transformation of the world's most populous nation" (The Pain Report, 6 December 2013).

Show us the "E"

The global equity market rally of 2013 (particularly over the latter period) has been characterised to a greater or lesser extent by PE (Price Earnings) expansion, aided by the abundant supply of cash globally. The price of a share (P) at any point in time needs to be linked to a company's underlying earnings (E) – current or prospective. It is this relationship that provides a sense of fundamental value at any one point in time. You often hear commentators talking about markets being over-valued (expensive), under-valued (cheap) or fair value. The recent lift in equity prices was not specifically supported by a commensurate rise in company earnings. This is not always a concern (particularly against the backdrop of improving economic circumstances) as markets often anticipate earnings growth ahead of time.

However, in the Australian market, we have not seen any growth in corporate earnings (on average) for two to three years and in the case of the US Dow Jones, whilst corporates have been delivering improved profit outcomes, price growth has now outstripped earnings growth for the first time since the GFC

S&P 500 Forward 12-Month EPS vs. Price: 10-Year



This re-rating of stocks is not beyond the realms of rational expectation as, by historical standards, the market probably still sits in the fair value range (not grossly over-priced). However, after a couple of stellar years on the US market, it is likely that we will see a pull-back during the early part of 2014. This will mean that any US or (in due course) Australian company that disappoints with earnings announcements (or related guidance) is likely to be sold off heavily in the short term.

Buffet's Stocking Picking - More than just Luck

We recently gained an insight into the investing prowess of Warren Buffet. The National Bureau of Economic Research published research confirming that Buffet (or more particularly Berkshire Hathaway, his investment company) had outperformed US Stocks and most mutual funds over the last 30 years.

Many theorists have argued that his ability to outperform the market was based on luck and that efficient market theory dictates that it is not possible for someone to consistently outperform the market. But the research indicates that luck has little to do with his success, instead concluding that his outperformance is driven by the use of leverage combined with a focus on acquiring undervalued quality stocks and assets. This would seem to confirm his reputation as somewhat of a contrarian investor and that he indeed puts into practice his adage of "being fearful when others are greedy and greedy only when others are fearful."

OUTLOOK

We can't help but feel that the RBA here in Australia has dropped the ball on interest rates. They have had ample data confirming that the Australian economy is continuing to struggle (as mining investment winds back), unemployment continues to creep higher, the AUD is still 5 cents to 6 cents higher than the RBA's own assessment of fair value and inflation ("trimmed mean") sits comfortably within their target range. The question on our lips is "why wouldn't you." Even the IMF (World Economic Update – 21 Jan'14) has warned major economies to keep "monetary policy accommodative" and rates as low as necessary whilst "fiscal consolidation continues". At the very least we shouldn't be seeing any moves by the RBA to raise rates in 2014 (notwithstanding what some commentators are saying) and this will be a continued positive for Australian corporates and the equity market.

Our analysis leads us to be constructive on equities in 2014. Global interest rates will likely remain low for some time (increasing the relative attractiveness of equities), economic growth continues to push higher (the consensus view for global growth in 2014 has risen to 3.6%, compared to GDP growth of around 2.8% in 2013) and company earnings are likely to rise further. Complimenting this fundamental view, the chartists are also looking for the latter part of 2014 to provide the technical set up for a three year bull market (we may not hold our breath). The consensus view for the ASX200 for 30 December'14 would have it sitting at around 5,750 (this is an averaging of chief economist, selected investment bank and broker views).

Of course the "bad news" is that it won't be all plain sailing; nor will all shares increase in value to the same extent – indeed some are likely to fall over the period. In 2013 when the Australia share market rose an average of 15%, we experienced two major corrections; the first of almost 12% in June'13 and a second, just over 8%, in late Nov'13. We are again like to see pull-backs in equity markets – the earliest being some time during the first quarter of 2014. As noted above, the US equity markets are vulnerable from a PE perspective and Australian corporate earnings may be insufficient to fully justify recent re-ratings of some stocks/sectors.

We anticipate softness in the Australian Market to persist through January'14 and early February'14, with a more significant pull-back in equity markets (here and in the US) in March'14. Based on the charts, the early part of the second half of the year (June/July) could also be challenging.

As a consequence of this view (ie short term volatility – medium term positive) we wouldn't necessarily be looking to commit additional funds into equity markets at this time (outside of specifically targeted stocks). After March, there may well be more attractive buying opportunities both here and abroad.

ASSET ALLOCATIONS

We are looking to position client portfolios as follows:

- **Australian Equities (Neutral):** We remain cautiously constructive on Australian stocks, particularly as we move into the second half of 2013. However, in the short term, we see the potential for some level of retracement.
- **Global Equities (Neutral):** The PE dynamic outlined above, together with technical analysis, looks set to deliver a pull back in the first quarter. However, medium term growth and earnings prospects remain positive.
- **Property (Underweight):** Listed Property has benefited from the flight to yield, but now appears to be in a correction phase as investors consider higher growth sectors.
- **Fixed Interest (Neutral):** Listed income securities continue to be an attractive fixed interest investment. Given the level of interest rates, it is preferable to hold a little less cash and a little more in income securities as part of any defensive allocation in portfolios.
- **Cash (Slightly Overweight):** As a result of our positions in other asset classes, cash is presently slightly overweight.

Regards

Andrew & Stephen
26 January 2014